Pacta Sunt Servanda – agreements must be performed in good faith

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Part - A

Introduction

As India propels itself on the growth trajectory, with our Prime Minister ably leading from the front, the bandwagon of the Indian promise is on a drumroll. Thus, attracting the attention of foreign investors, resultantly as an economy, we are increasingly integrating with the world with the increased FDI inflows. This fact is also established by the statistical figures published in the economic survey of India 2015-16 where it is stated that the correlation between India and the world economy has increased from a factor of 0.2 for the period 1991-2002 to a factor of 0.42 for the current period.

Owing to such integration, international financial transactions are the norm of businesses today and our profession has the privilege of being the first choice for advice on such transaction. While advising on international financial transactions, the aspect of international tax is a significant focus area where interpretation of tax treaties along with Income-tax Act, 1961 is crucial.

The judiciary has played a significant role in India in developing our understanding of international tax treaties with landmark rulings such as ***Azadi Bachao Andolan (2003) 263 ITR 706 (SC)*** and ***Kulandagan Chettiar (2004) 267 ITR 654 (SC).*** The Madras High Court ruling in the Writ Petition Nos. 17241 to 17243 delivered in April 2016 where constitutional validity of Section 94-A of the Income-tax Act, 1961, has been challenged is another latest landmark ruling to join the league of these haloed rulings.

The author in this article has discussed the significance of the Madras High Court ruling while also analysing the decision of Pune Tribunal in the case of ***Serum Institute of India limited (2015) 40 ITR (Trib) 0684 (Pune)*** in light of the Madras High Court ruling, as the latter case law has become a significant precedent in Tax Treaty interpretation in reference to Sec. 206AA of the Income-tax Act, 1961, versus the treaty rates.

Part-B

Writ Petition Nos. 17241 to 17243 – [2016] Madras High Court

Petitioners Challenge

The petitioner had filed a writ petition before Madras HC challenging the CBDT Press release dated Nov 1, 2013 notifying Cyprus as non-cooperative jurisdiction and also challenged the constitutional validity of Sec 94A which provides for tax deduction at highest rate of 30% on payments made to any Cyprus resident. Revenue had held the assessee in default u/s 201(1)/(1A) for not deducting TDS as per the mandate of Sec 94A in respect of contract entered into with a Cyprus company.

The main grounds raised by the appellant in support of its contention are provided herebelow:

- Sec. 94-A has conferred sweeping powers upon the Central Government to specify any country as a notified jurisdictional area in relation to transactions entered into by any assesse, **irrespective of whether such country is one, with whom a bilateral treaty has already been entered into or not**.
- The petitioner has also contended that the State (India) has an obligation under Article 51(c) of the Constitution, which is part of the Directive Principles of the State Policy, to foster respect for Treaty obligations in the dealings of organized people with one another.
- The Treaty entered into by the Government is virtually a law under Article 253 of The Constitution and hence, neither the Parliament can make any law that would go contrary to the treaty nor the Government can take any executive action to annul the effect of the Treaty so long as the Treaty is in force.
- The petitioner has also placed strong reliance upon the Supreme Court decision rendered in the case of ***Union of India vs. Azadi Bachao Andolan [2004 (10) SCC 1]*** to contend that Sec. 90 of the Income-tax Act, 1961, is specifically intended to enable and empower the Central Government to issue a notification for implementation of the terms of a Double Taxation Avoidance Agreement and that when it happens, ***the provisions of such an Agreement would operate, even if inconsistent with the provisions of the Income-tax Act, 1961.***
- The petitioner has also challenged Sec. 94-A of the Income-tax Act, 1961, on the basis of **Vienna Convention on the Law of Treaties,** where Union of India cannot invoke the provisions of the Internal Law namely Sec. 94A of the Income-tax Act, 1961, as a justification to annul a bilateral treaty

Ruling of the High Court

The Madras High Court while delivering its judgment has dealt with the matters on hand in the following manner:

- **Scope of International treaty under The Constitution**
  Before discussing the scope of International Treaty under the Constitutional scheme, the High Court has delved upon the Philosophical Concepts of Dvaitha (dualism) and Advaitha (monism), and further discussed that the principles of international law also contain two theories namely (i) monism and (ii) dualism. Monism is the idea that assumes that international law and national law are nothing but two components of a single legal system or body of knowledge. In contrast, dualistic theory assumes that international law and internal law of States are two separate and distinct legal systems.
  In case of India, the Supreme Court has held in ***Jolly George Varghese vs. The Bank of Cochin [AIR 1980 SC 470]***, *that the executive power of the Government of India to enter into international Treaties does not mean that international law, ipso facto, is enforceable upon ratification.* ***The Indian Constitution follows the 'dualistic'***

doctrine with respect to international law. *Consequently, international treaties do not automatically form part of international law, unless incorporated into the legal system by a legislation made by the Parliament.*

Thus as the **Indian Constitution follows dualistic doctrine** with respect to international law, it must be taken that an international Treaty, can be enforced only so long as it is not in conflict with the municipal laws of the State. The Madras High Court in its ruling on the Writ Petition Nos. 17241… has gone on to list several further rulings of the Supreme Court where the dualistic theory is highlighted and the well-established principle that, international law can be followed when the municipal law is not in conflict with the same & the principles upon which such conventions or treaties are founded can be traced to the common law, such as the Supreme Court decision in the case of ***M.V. Elizabeth vs. Harwan Investment & Trading Private Limited [1993 Supp. (2) SCC 433]***

- **Reliance upon the decision in *Azadi Bachao Andolan [2004 (10) SCC 1]***

  As the Supreme Court decision in the case of ***Azadi Bachao Andolan [2004 (10) SCC 1]*** forms the sheet anchor of the case of the petitioners, the Madras High Court in its ruling on the Writ Petition Nos. 17241…has dealt with the Supreme Court decision in a detailed manner and also the decision in the case of ***Kulandagan Chettiar (2004) 267 ITR 654 (SC)***

  The Madras High Court after discussing the principles emanating from the Supreme Court decisions in the case of ***Azadi Bachao Andolan [2004 (10) SCC 1]*** and of ***Kulandagan Chettiar (2004) 267 ITR 654 (SC)*** concluded that Sec.90 (2) of the Income-tax Act, 1961, merely deals with the option given to an assessee, to whom an agreement referred to in Sec. 90(1) applies, to choose either the provisions of the Treaty or the provisions of the Act, whichever is more beneficial to him. However, Sec. 90(2) does not deal with the question of conflict between a Treaty and the provisions of a statute. HC held that Sec. 90 did not either expressly or by necessary implication prescribe that the law made by Parliament would stand eclipsed to the extent inconsistent with DTAA and remarked that "it is impossible to think that the supremacy of the Parliament could be compromised by the Executive entering into a Treaty".

  Further no question arose directly either in Azadi Bachao Andolan or in Kulandagan Chettiar as to whether or not the Parliament has the power to make a law in respect of a matter covered by a Treaty. **Therefore, the observations found in these two decisions, to the effect that the provisions of the treaty will have effect even if they are in conflict with the provisions of the statute, cannot be stretched too far to conclude that the Parliament does not have the power to make a law in respect of a matter covered by a treaty.**

- **Argument based on Vienna Convention**

  The Madras High Court noted that the Vienna Convention on the Law of Treaties, which entered into force on 27.1.1980, obliges the Member States to treat every Treaty in force, as binding upon the parties thereto. Articles 26 and 27 of the Vienna Convention contain the doctrine of '***Pacta Sunt Servanda'.*** It lays down that every

Treaty in force is binding upon the parties to it and must be performed in good faith and a party may not invoke the provisions of its internal law as a justification for its failure to perform a Treaty.

However, the Madras High Court has also noted that India has not ratified the Vienna Convention, though a reference to the same, has been made in a few decisions of the Courts. And even if rule of ***Pacta Sunt Servanda*** contained in Article 26 of the Vienna Convention were to be invoked, on the basis that the same was part of the customary international law, the petitioners would not be better off. This is for the reason that Article 26 of the Vienna Convention obliges both the contracting parties to perform their obligations in good faith. One of the four purposes for which, an agreement could be entered into by the Central Government under Sec. 90(1), is for the exchange of information. If one of the parties to the Treaty fails to provide necessary information, then such a party is in breach of the obligation under Article 26 of the Vienna Convention. The beneficiary of such a breach of obligation by one of the contracting parties (like the assesse herein) cannot invoke the Vienna Convention to prevent the other contracting party (India in this case) from taking recourse to internal law, to address the issue.

Hon'ble Madras High Court quoted from G20 leaders' April 2009 statement wherein it was resolved to take action against non-cooperative jurisdictions, including tax havens. HC also held that Mutual Agreement Procedure clause in the treaty cannot oust Parliament's jurisdiction to enact a law and the Executive to issue a Notification in exercise of the power conferred by such a law.

- Thus on the basis of the above reasoning the Madras High Court has ruled against the appellant's petition, upheld the validity of the press note as also Sec 94A of the Act.

Part - C

Serum Institute of India limited (2015) 40 ITR (Trib) 0684 (Pune)

In the Serum Institute of India Limited case, the matter before the tribunal, was whether Sec. 206AA of the Income-tax Act, 1961, would override the provisions of the Double Taxation Avoidance Agreement (DTAA), in a situation where non-resident taxpayer did not furnish PAN, thereby necessitating a minimum withholding tax rate of 20% irrespective of the rate provided in the DTAA.

Before the CIT(A) this matter had been decided in the favour of the assesse, where the CIT(A) had relied on the Supreme Court decision of ***Azadi Bachao Andolan [2004 (10) SCC 1]*** to rule that provisions made in the DTAAs would prevail over the general provisions contained in the Act, to the extent they were more beneficial to the taxpayer and therefore DTAA rates would prevail over rates prescribed in Sec. 206AA of the Act.

When the revenue went in appeal before the tribunal against the ruling of the CIT(A), the Pune Tribunal ruled in favour of the assesee, where the tribunal observed that DTAA's entered into between India and the other relevant countries in the present context provided for scope of taxation and/ or a rate of taxation, which was different from the scope/rate prescribed under the Income-tax Act, 1961. Charging Sec. 4, as well as Sec. 5 of the Income-tax Act, 1961 which deals with the principle of ascertainment of total income under the Act, were also subordinate to the principle enshrined in Sec. 90(2) as held by the Supreme Court in the case of ***Azadi Bachao Andolan [2004 (10) SCC 1].*** Sec. 206AA of the Income-tax Act, 1961, was not a charging section, but is a part of the procedural provisions dealing with collection and deduction of tax at source, and it could not override the charging sections, viz. sections 4 and 5 of the Income-tax Act, 1961.

Part - D

Conclusion

The decision of Pune bench of Income-tax Appellate Tribunal(ITAT) in Serum Institute of India Ltd. case has been followed by the Bangalore bench of ITAT in the case of ***Infosys BPO Limited (2015) 154 ITD 0816 (Bangalore)***. On reading the above decisions in light of the Madras High Court decision on the **Writ Petition Nos. 17241 to 17243 – [2016] Mad HC**, a question that comes to mind is whether the tribunal rulings have been overturned by the Madras High Court ruling in principle though the subject matter of appeal in the Tribunal cases and the High Court case are distinct. The fact is that the tribunal ruling and HC ruling operate on a different plane altogether. Both, in my humble, view appear to be good in law.

Where the Central Government has entered into an agreement with Government of any Country outside India for granting of relief of tax, or as the case may be avoidance of double taxation, then the provisions as per the agreement (Treaty) will prevail over the general provisions contained in the Income Tax Act, to the extent they are beneficial to the assessee. Following this principle the Pune bench of Income-tax Appellate Tribunal in Serum Institute of India Ltd., and the Bangalore bench of ITAT in the case of ***Infosys BPO Limited (2015) 154 ITD 0816 (Bangalore)***, extended the benefit of Treaty override to the assesse.

The Madras High court in the writ petition Nos. 17241 to 17243 has laid out the principle that though there is a binding Treaty, Section 94 A empowers Central Government to notify any country or territory as 'notified jurisdictional area' in relation to transactions entered into by any assessee when such country or territory fails to effect exchange of information with the Government of India. Section 94 A is introduced in the Income Tax Act, 1961 in 2011 as an anti-avoidance measure.

Besides the objective of granting a relief from double tax, the tax treaties also have an objective for Exchange of Information on tax matters between tax authorities of the contracting states. As per the India - Cyprus DTAA (Treaty) both the contracting states (India and Cyprus) have a legal obligation to exchange such information as is necessary for carrying out the provisions of the agreement or of domestic laws of the contracting states, in particular for the prevention of fraud or evasion of taxes.

Hence, exchange of information being one of the objectives of the Tax Treaties, since Cyprus has not been providing the information requested by the Indian Tax authorities under the exchange of information provisions of the DTAA, Cyprus is notified as 'notified jurisdictional area' under section 94 A of the Income Tax Act. The ramification of this notification on the India – Cyprus Tax treaty will also be worth evaluating.

Another way of looking at this development in law is that, due to the **Dualistic theory** followed in our Constitution, the International Convention to which India is a party can be invoked so long as the provisions of such treaty or convention are not in conflict with the municipal law. Hence, could a view be taken that, provisions of Sec. 206AA being a municipal law override the treaty provisions? It is pertinent to note that the Hon'ble Supreme Court has admitted SLP against Madras HC judgement upholding Cyprus notification u/sc. 94-A of the Income-tax Act. Only time will tell as to what would be the law of the land.

Advising the clients on the applicable tax deduction rates for international financial transactions is a critical function performed by tax professionals to ensure compliance by the client with the Income-tax law. The author here has presented a study of two recent case laws in the arena of tax deduction at source on international financial transactions which require to be noted cautiously while advising our clients. Both the decisions discussed above are open to challenge before the higher forums and have not yet attained finality, nevertheless they make a pertinent reading for the tax professional who advise clients on international tax matters.